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• SUPREME COURT OF CANADA WEIGHS IN ON CONDUCT BARRING LIMITATION •

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In a much awaited decision in *Peracomo Inc. v. Telus Communications Co.*,[1] the Supreme Court of Canada examined the standard of fault constituting conduct barring limitation under Article 4 of the Convention on Limitation of Liability for Maritime Claims, 1976 ("Limitation Convention") and whether the same behaviour constitutes wilful misconduct voiding insurance coverage under the *Marine Insurance Act*.[2]

Mr. Vallée is a crab fisherman from the lower St. Lawrence River. A fibre-optic submarine cable became entangled with his fishing gear. He raised the cable to the deck of his ship and proceeded to cut the cable with a chain saw. He was under the mistaken belief that the fibre-optic cable was not in use. That belief was based on a handwritten note on some sort of map that he had briefly seen in a museum. The marine charts of the area indicated the presence of a live cable. The result was $1 million of damage. As the trial judge put it, Mr. Vallée was a good man who did a very stupid thing.

The *Marine Liability Act*[3] gives force of law in Canada to the Limitation Convention. It also provides that the limitation of liability of ships with less than 300 gross tonnage, such as this fishing boat, is of CAD $500,000.

The cable owner argued that the fisherman was not entitled to limit his liability. Intentionally cutting the submarine cable constituted conduct barring limitation under Article 4 of the Limitation Convention, because it was done recklessly with knowledge that the loss would probably result. To compound Mr. Vallée's problems, his insurers claimed that the same behaviour also

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constituted wilful misconduct that voids the insurer's obligation to indemnify. Both issues turned on the fisherman's degree of fault.

All the justices agreed that the behaviour in question did not meet the threshold of conduct barring limitation under the Limitation Convention. It was insufficient that the person liable intended to perform the act—namely, cutting the cable. Rather, in order to break limitation, it must be proven that the person intended to cause the loss that actually resulted or had knowledge that the loss would probably occur—namely, stopping fibre-optic traffic.

The Court examined a number of decisions interpreting the Limitation Convention, including the "Leerort" as well as the Warsaw Convention on carriage by air, which inspired Article 4. The court pointed out that Article 4 focuses on an intention to cause the loss, while the right to limit under the Convention relates more generally to the claim. The limitation is expressed in broad and generic terms, while the intention required to break the limitation relates to specific consequences of the conduct of the person liable.

The fisherman held the sincere, though mistaken, belief that the cable was useless. Although that belief was based on inadequate information, in cutting the cable, he did not intend to cause a loss nor did he know the probable consequences of his actions.

On the other hand, the majority of the court held that the standard under s. 53 of the *Marine Insurance Act* of "wilful misconduct" was a lower benchmark. A clear distinction was drawn between the purpose and text of Article 4 of the Limitation Convention and s. 53 of the *Marine Insurance Act*. The standard of fault is not the same.

The fisherman clearly had a duty to be aware of the cable, and he failed miserably in that regard. His acts were so far outside the range of conduct to be expected in the circumstances as to constitute misconduct. The issue was whether that misconduct was wilful.

For the majority of the court, wilful misconduct includes not only intentional wrongdoing but also conduct exhibiting reckless indifference in the face of a duty to know. The fisherman's misconduct was wilful in that he knew he was cutting the submarine cable. It is not necessary to also demonstrate that he knew that the harm would occur. It is sufficient that he ran an unreasonable risk with subjective knowledge of that risk and indifference as to the consequences. To hold otherwise is to "conflate recklessness with intention". As the court put it, those "who take unreasonable risks of which they are subjectively aware often wrongly believe that the risk which they decide to take will not result in harm".[4] That is the essence of recklessness.

For insurance purposes, the fact that the fisherman believed that the cable was not in use is beside the point. He knew that he was cutting a submarine cable. He adverted to the risk that it could be in use but failed to make further inquiries in order to confirm or dispel his belief that the cable was abandoned. Wilful misconduct does not require either intention to cause a loss or subjective knowledge that the loss would probably occur.

One of the Justices of the Supreme Court dissented on the issue of wilful misconduct. Justice Wagner focused on the word "wilful". In his view, the fact that a reasonable person ought to have known, or that a person had a duty to know, does not suffice to characterize the misconduct as wilful. It is also necessary to establish that the person intended to cause a loss or to prove gross negligence or misconduct in which there is a very marked departure from the conduct of a reasonable person.

The decision reaffirms the almost unbreakable nature of the limitations under the Convention while distinguishing between conduct barring limitation and wilful misconduct in a marine insurance context.

It will be of interest to P&I Clubs and other marine insurers. Even if the behaviour of the insured is not so egregious as to meet the fault standard of Article 4 of the Limitation Convention, it may nevertheless constitute wilful misconduct allowing the insurer to deny coverage. Conversely, this decision may cause concern to ship owners who, much like this fisherman, may find themselves able to limit liability but unable to look to their insurers to constitute that limitation fund.

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1 [2014] S.C.J. No. 29, 2014 SCC 29.

2 S.C. 1993, c. 22.

3 S.C. 2001, c. 6.

4 *Supra* note 1, para. 66.

• THE DAY THE DISPUTE WAS DISCOVERED … •

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Recently, the Ontario Superior Court of Justice considered the "discoverability principle" in the context of a dispute between insurers over which one should pay damages arising out of a car accident in *Economical Insurance v. Nationwide Mutual Insurance*.[1]

In March 2003, Sandra Williams and her passenger, Paul Betts, were injured when their vehicle was struck by a car driven by Ginger Lee Fink. For reasons unknown, Ms. Fink reported to investigating police officers that she did not have insurance at the time of the accident (when in fact, she did). Accordingly, she was charged with operating a motor vehicle without insurance.

As Ms. Fink purported to be uninsured at the time of the accident, Ms. Williams commenced an action against her own insurer, Economical Mutual Insurance Company, in respect of the injuries and losses she sustained as a result of the accident ("the Williams Action"). Economical settled this claim for $186,296.04 and commenced an action against Ms. Fink to recover the amount it paid to settle with Ms. Williams ("the Fink Action"). Economical ultimately obtained default judgment against Ms. Fink but was unsuccessful in locating her for the purpose of enforcing the judgment. Eventually, Economical closed its file without recovering on its judgment against Ms. Fink.

Subsequently, Mr. Betts sued both Ms. Williams and Ms. Fink in respect of the injuries and losses he sustained as a result of the accident ("the Betts Action"). Economical responded to this action on behalf of its insured, Ms. Williams.

During the course of defending the Betts Action, Economical learned that Ms. Fink did, in fact, have insurance at the time of the accident. However, the Economical personnel and counsel handling the Betts Action were unaware that it had an unsatisfied judgment against Ms. Fink arising out of the Fink Action. It was not until the conclusion of the Betts Action in July 2010 that Economical personnel handling that action learned that Economical had a judgment in the Fink Action to which Ms. Fink's insurer, Nationwide Insurance Company, should respond. Accordingly, Economical sought to collect on its judgment from the Fink Action from Nationwide pursuant to s. 258(1) of the *Insurance Act*.[2] Nationwide refused to pay.

At issue was whether Economical had commenced its recovery efforts from Nationwide in time. In addressing this issue, the court noted that the applicable limitation period for such a claim was two years, which began to run on the date Economical knew, or in the exercise of reasonable diligence ought to have known, of its claim against Nationwide. The court also pointed out that a claim of this nature is not "discovered" until the plaintiff discovers "that the at-fault driver…was in fact insured pursuant to a valid policy of motor vehicle insurance".[3]

Nationwide did not dispute the foregoing principles but asserted that Economical did not exercise proper diligence in trying to locate Ms. Fink and determine whether she had insurance. It also argued that during its defence of the Betts Action in 2007, Economical actually learned that Ms. Fink had insurance such that the actual date of discovery was in 2007, not 2010 upon the resolution of the Betts Action, as was asserted by Economical.

In dismissing Nationwide's argument that Economical did not exercise proper diligence in trying to locate Ms. Fink to determine whether she had insurance, the court held that Economical's efforts to locate her were reasonable in light of the police information that Ms. Fink did not have insurance. The court accepted Economical's argument that since an insured driver involved in a serious accident almost invariably discloses his or her insurance status so his or her insurer will respond to any claims, it was reasonable for Economical to accept at face value Ms. Fink's statement to police that she did not have insurance at the time of the accident. The court held that Economical had no reason to take further steps or incur further expenses in confirming Ms. Fink's apparent lack of insurance.

The more difficult question was whether Economical was fixed with knowledge of Ms. Fink's insured status once it learned of same during its defence of Ms. Williams in the Betts Action. In considering this issue, the court was mindful that when adjusting and defending personal injury claims in insurance cases, insurers keep cases separate to protect privacy interests and to defend or advance claims diligently. The court specifically noted that implying or requiring communication among persons and counsel on different, but related, claims could compromise these principles. With that in mind, the court noted that the Economical personnel involved in defending the Williams Action and pursuing the Fink Action were different from those involved in defending the Betts Action. As such, the "left hand" did not know what the "right hand" was doing, and for good reason rather than lack of diligence.

In light of the foregoing, the court accepted that although while defending the Betts Action, Economical learned that Ms. Fink had insurance sometime in late 2007, its employees involved in defending that action did not know there was an unsatisfied judgment against Ms. Fink to which her insurance could respond. It was not until the Betts Action resolved when, as part of the file-closing process, a team leader at Economical reviewed the Betts file and discovered the judgment. As fate would have it, this team leader turned out to be the person that adjusted the Williams Action and Fink Action. Recognizing the names of the various parties, this team leader realized that Economical had an unsatisfied judgment against Ms. Fink to which Nationwide ought to respond. The court therefore held that it was not until this point in July 2010 that Economical "discovered" for the purposes of the Williams Action and Fink Action that Ms. Fink was insured.

The court ultimately held that Economical was entitled to collect on its judgment in the Fink Action from Ms. Fink's insurer, Nationwide, because it had taken steps to do so within the applicable limitation period.

[*Editor's note*: **James Prior** practises Insurance Law and is an Associate at the Waterloo office of Miller Thomson. James's legal practice focuses on the area of insurance defence, including the defence of personal injury and property damage claims as well as commercial general liability and subrogated recovery matters.]

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1 [2014] O.J. No. 1644, 2014 ONSC 2080.

2 R.S.O. 1990, c. I.8.

3 *Supra* note 1, para. 15.

• OSFI ISSUES NEW DRAFT GUIDELINE ON RESIDENTIAL MORTGAGE INSURANCE •

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Introduction

On April 14, 2014, the Office of the Superintendent of Financial Institutions Canada ("OSFI") released for consultation *Draft Guideline B-21 Residential Mortgage Insurance Underwriting Practices and Procedures*. Once finalized, the draft guideline will apply to all federally regulated insurers that are governed by the *Insurance Companies Act*[1] and provide insurance for residential mortgage loans in Canada and/or reinsurance for such insured loans.[2] The draft guideline sets out OSFI's prudential expectations for residential mortgage insurance underwriting and related activities in the form of six fundamental principles; it also outlines increased disclosure obligations on insurers issuing such insurance.

Six Fundamental Principles

The draft guideline articulates six fundamental principles for sound residential mortgage insurance underwriting.

Residential Mortgage Insurance Underwriting Plan

Under the draft guideline, insurers engaged in residential mortgage insurance underwriting should have a comprehensive residential mortgage insurance underwriting plan. The plan should be developed and implemented by the insurer's senior management and should contain the insurer's key mortgage insurance underwriting policies, including its

- business objectives;
- risk management policies;
- complete set of mortgage insurance products, requirements, and conditions for lenders for mortgage insurance coverage; and
- policies for assessing lenders' underwriting and compliance with their mortgage insurance agreements.

The insurer's board is expected to provide guidance to, and oversee senior management's role in, implementing the plan.

Establishing Standards for Initial Assessment and Qualification of Mortgage Lenders

The draft guideline requires insurers to establish sound standards for initially assessing and qualifying mortgage lenders for mortgage insurance coverage. To carry out an initial assessment of a mortgage lender, the insurer is expected to establish sound qualification standards by considering the particular lender's

- financial soundness;
- mortgage loan underwriting experience;
- ability to provide timely and accurate information on the performance of mortgage loans; and
- delinquency, foreclosure, and claims management processes.

Mortgage Insurance Criteria and Insurance Coverage Requirements for Lenders

An insurer issuing residential mortgage insurance should establish prudent underwriting criteria that specify the characteristics and parameters of insurable mortgage loans for lenders. At a minimum, the criteria for mortgage loans for each mortgage insurance product and insurance type should cover certain components, such as

- mortgage loan parameters,
- the borrower's background and the borrower's willingness and capacity to service debt; and
- underlying mortgage property/mortgage insurance premiums.

To help control risk, the draft guideline also requires insurers to promote sound mortgage underwriting and loan management practices consistent with the insurer's interests. In order to do so, the insurer must outline requirements, conditions, and any other obligations to be adhered to by residential mortgage lenders, including elements such as

- a description of the mortgage insurance coverage;
- a condition for lenders to provide complete, accurate, and timely information; and
- requirements for lenders to exercise documentation retention.

Periodic Assessments of Lenders' Underwriting Practices

In order to measure, track, and control risk, the draft guideline expects insurers to review lenders' underwriting policies on a periodic basis and to assess and verify the degree to which the insurer's stated criteria and insurance policies are being followed by lenders. Insurers should establish clear policies on the types, methods, and frequency of reviews and remedial action to be taken in order to address inadequate underwriting practices by lenders.

Assessment and Validation of Underwriting Systems, Models and Underwriters' Processes

Under the draft guideline, insurers engaged in residential mortgage insurance underwriting should periodically assess and validate their insurance underwriting systems and models to ensure compliance with the residential mortgage insurance underwriting plan. For automated underwriting systems, the insurer should establish programmes to monitor continuously and audit the information received on mortgage loans, and take immediate remedial action to address any identified weaknesses. Insurers should

- train their underwriting personnel appropriately;
- ensure that underwriters' decisions are well documented; and
- develop appropriate underwriting processes and practices that are regularly monitored and evaluated to assess compliance and consistency in decision making.

Effective Portfolio Risk Management and Other Risk Mitigation

Insurers should have effective portfolio risk management practices, including a stress-testing regime that considers "exceptional, but plausible" events and scenarios and the corresponding impact on asset and liability-side portfolios. Based on the assessment of risk, insurers are expected to adjust their mortgage insurance underwriting criteria and premium schedules appropriately to align with the objectives outlined in their residential mortgage insurance underwriting plan. For higher-risk insured mortgage loans, insurers should exercise heightened caution through

- greater board and senior management oversight;
- increased reporting to and monitoring by senior management and the board;
- clear internal time limits consistent with the residential mortgage insurance underwriting plan;
- stronger internal controls; and

- increased oversight of higher-risk mortgage lenders.

Increased Disclosure Requirements

The draft guideline also imposes increased and somewhat onerous disclosure requirements on insurers, although it is not clear exactly how such disclosure should be made, except that it should be "publicly disclosed" to "market participants". The disclosure requirements in the draft guideline include publishing quarterly information relating to residential insurance portfolios and discussions of the potential impact of an economic downturn on insured mortgage loans. The draft guideline requires insurers to provide a breakdown of mortgage loans insured during the past 12 months as well as the total stock of insured mortgage loans divided by mortgage insurance type and further categorised by volume, loan to value, amortisation, geography, and delinquencies.

Supervisory Requirements

The draft guideline not only requires an insurer to maintain and provide to OSFI, on request, its residential mortgage insurance underwriting plan and associated management reports but also expects an insurer to inform OSFI promptly of any mortgage insurance underwriting issues that could materially affect the insuer's financial condition. The draft guideline gives OSFI the power to take, or require the board and/or senior management to take, necessary corrective measures to deal with issues of financial soundness.

Comment

Through the draft guideline, OSFI has proposed tightening mortgage insurance and lending practices. OSFI is initiating a public consultation on the draft guideline, for which comments are due by May 23, 2014. OSFI plans to review and consider all comments before finalising the draft guideline later in 2014, at which time, it will provide further guidance on implementation issues, such as the required time for insurers and other stakeholders to adjust their internal systems, policies, and processes. A summary of stakeholder comments and OSFI's associated responses will be provided when the final guideline is released.

The draft guideline is consistent with various recent OSFI initiatives requiring insurers to identify, monitor, and report on the risks undertaken in their underwriting activities. Once finalised, the requirements of the draft guideline will need to be incorporated into the insurer's risk appetite framework and ultimately dealt with as part of the insurer's own regulatory solvency assessment.

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1 S.C. 1991, c. 47.

2 Any reference to "mortgage insurance" in this article also includes mortgage loan reinsurance. The remainder of this article makes reference only to mortgage insurance unless the distinction is required.